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IN THE

Supreme Court of the United States

October Term, 1972

No. 72-486

FEDERAL POWER COMMISSION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

No. 72-488

TEXAS GAS TRANSMISSION CORPORATION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

On Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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BRIEF FOR RESPONDENT AMERICAN PUBLIC GAS ASSOCIATION*

STATEMENT OF THE CASE

A. Background

The passage of Section 167 of the Internal Revenue Act of 1954 raised the issue for regulatory bodies regarding the proper ratemaking treatment of tax savings effected through the use of liberalized (accelerated) depreciation.[1] Prior to the issuance in 1964 of Opinion No. 417 in *Alabama-Tennessee Natural Gas*

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*The American Public Gas Association (APGA) is the national association of municipal gas distribution systems.

[1]Congress enacted section 167 as an investment incentive for the business community generally. It enables taxpayers to write off between two-thirds and three-quarters of post-1933 investments in the first half of a property's estimated life.

Co.,[2] the Federal Power Commission (FPC or Commission) had taken the view that section 167 mandatorily required the Commission to permit affected natural gas companies to compute their taxes for ratemaking purposes on the basis of straight line depreciation even though their actual taxes were computed on the basis of liberalized depreciation. This so-called "normalization" accounting procedure resulted in rates to gas consumers which reflected a higher tax component than the companies actually paid. Thus, as the Commission noted in its *Alabama-Tennessee* opinion, in the nine years that liberalized depreciation reductions were available, "the natural gas pipelines and electric utilities have, respectively, accumulated $286,320,000 and $540,690,000 of deferred tax funds."[3] The Commission emphasized in its *Alabama-Tennessee* opinion that it had heretofore permitted normalization by natural gas companies based on the misconception that it was acting in accord with the Congressional mandate of section 167 of the Tax Act.[4] Once the Commission was disabused of this erroneous legal notion by various U.S. Courts of Appeals,[5] it reached for the first time the issue of "the proper ratemaking treatment for Alabama-Tennessee and other regulated companies which claim the benefits of liberalized depreciation on their tax returns."[6]

Freed from the imagined restraints of the 1954 Tax Act, the Commission looked to the statutory requirements of the Natural Gas Act, stating as follows:[7]

> We are, therefore guided in our determination by two fundamental considerations which are basic to the determination of just and reasonable rates under

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[2] Alabama-Tennessee Natural Gas Co., 31 F.P.C. 208, 928 (1964), *aff'd*, 359 F.2d 318 (5th Cir. 1966), *cert. denied*, 385 U.S. 847.

[3] 31 F.P.C. at 209 (footnote omitted).

[4] 31 F.P.C. at 211-12. *E.g.*, Amere Gas Util. Co., 15 F.P.C. 760 (1956).

[5] Panhandle Eastern Pipe Line Co. v. FPC, 316 F.2d 659 (D.C. Cir. 1963), *cert. denied*, 375 U.S. 881; City of Lexington, Ky. v. FPC, 295 F.2d 109 (4th Cir. 1961); El Paso Natural Gas Co. v. FPC, 281 F.2d 567 (5th Cir. 1960), *cert. denied*, 366 U.S. 912.

[6] 31 F.P.C. at 210.

[7] 31 F.P.C. at 214 (emphasis added).

the Natural Gas Act. *First is the rule of law that only the amount of Federal income taxes actually payable if a reasonable return is earned can be included as an operating expense to be covered by the utilities' rates.* As early as 1922 the Supreme Court in the case of *Galveston Electric Co.* v. *Galveston*, 258 U.S. 388 (1922) ruled that rates should cover as an operating expense " * * * all taxes which would be payable if a fair return were earned * * * " (p. 399)

Another consideration basic to our determination herein is our statutory responsibility under the Natural Gas Act to assure that natural gas is sold in interstate commerce for resale at the lowest reasonable rate consistent with the maintenance of adequate service. As the Supreme Court recently stated in *Atlantic Refining Co.* v. *Public Service Commission*, 360 U.S. 378, 388 (1959):

> The purpose of the Natural Gas Act was to underwrite just and reasonable rates to the consumers of natural gas. Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944). As the original § 7(c) provided, it was "the intention of Congress that natural gas shall be sold in interstate commerce for resale for ultimate public consumption for domestic, commercial, industrial, or any other use at the lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest." 52 Stat. 825. The Act was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges.

The Commission then addressed itself to "the practical consequences of the use of liberalized depreciation."[8] The Commission found that the natural gas companies and electric utilities participating in the proceeding had presented no factual basis to support their thesis of tax deferral, i.e., that the use of section 167 must result in an increase in future taxes equalling

[8] 31 F.P.C. at 215.

the reduction of present taxes.[9] On the other hand, the Commission agreed with the testimony and exhibits of Melwood Van Scoyoc which, as the Commission found, established:

> * * * that the use of liberalized depreciation deductions produced a tax saving; that flow-through of these savings to consumers would not burden future taxpayers; and that such flow-through resulted in stable rates and did not impair the financial integrity of the company or adversely affect its ability to attract capital for plant expansion.[10]

On review, the United States Court of Appeals for the Fifth Circuit upheld in full the Commission's decision to require flow through of the tax savings resulting from liberalized depreciation.[11] As to the effect of section 167 of the 1954 Tax Act, the Court cited with approval the following excerpt from the Commission's brief:[12]

> *El Paso Natural Gas Company* [and other cases] "purged [the Federal Power Commission] of the erroneous legal view which it had previously believed compelled a contrary result" and "freed the Commission's hand to make the instant reevaluation of the problem."

And as to the effect of the Natural Gas Act upon the issue of the proper treatment of the tax savings effected by liberalized depreciation, the Court stated as follows:[13]

> Under the flow-through treatment of liberalized depreciation, *the ratepayers reimburse the utility for federal income taxes the regulated utility actually pays.* The utility does not accumulate capital funds

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[9] *Id.*

[10] *Id.*

[11] Alabama-Tennessee Natural Gas Co. v. FPC, 359 F.2d 318 (5th Cir. 1966).

[12] *Id.* at 330.

[13] *Id.* at 327 (emphasis added).

that are, in effect, enforced contributions from consumers. Flow-through is in accord with *the established principle the Commission has "consistently held that consumers should be charged for only the actual liability for Federal income taxes.* * * *" United Fuel Gas Company, 12 F.P.C. 251, 264-65 (1953).

The Court emphasized that under accepted regulatory concepts, "utility company shareholders (investors), not the consumers, furnish the capital necessary for the operation of the business."[14] Thus since liberalized depreciation creates a tax saving for the natural gas industry, to permit normalization would improperly have the effect of requiring the gas consumers not only to pay a fair return on the utility's capital but also to contribute part of that capital.[15] The U.S. Supreme Court denied ceriorari.[16]

The commission continued, consistent with the "actual taxes paid" principle of the Natural Gas Act, to require flow through (even of companies which switched back to straight line depreciation[17]) until the present litigation began following enactment of the Tax Reform Act of 1969.

B. The Proceedings Below

Following enactment of § 441 of the Tax Reform Act of 1969 which *inter alia* permitted affected utilities using flow through the option *with regard to post-1969 expansion property only* to switch to straight line depreciation or with the approval of the appropriate regulatory body, to switch to normalization, the Commission on May 15, 1970, issued Order No. 404 ("Statement of Policy", Docket No. R-387)[18] per-

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[14] *Id.* at 327 (citations omitted).

[15] *Id.* at 327-28, 336-39.

[16] Alabama-Tennessee Natural Gas Co. v. FPC, 385 U.S. 847 (1966).

[17] *E.g.*, Midwestern Gas Transmission Co., 36 F.P.C. 61, 599 (1966), *aff'd*, 388 F.2d 444 (7th Cir. 1968), *cert. denied*, 392 U.S. 928 (1968).

[18] 43 F.P.C. 740 (1970).

mitting "electing" utilities under its jurisdiction to switch to normalization as to post-1969 expansion property. The Commission reasoned that since the affected utilities had the automatic statutory right to switch to straight line as to post-1969 expansion property and since normalization was more favorable to consumers than straight line,[19] it was in the public interest to allow normalization. Thus Order No. 404, which was affirmed by the court below, is not inconsistent with the "actual taxes paid" principle of the Natural Gas Act in that it allowed a deviation from flow through *only* as to that property (i.e. post-1969 expansion property) as to which utilities had an automatic right under § 441 of the 1969 Tax Reform Act to switch to straight line depreciation or with the approval of the appropriate regulatory body, to normalization.

In its Opinion No. 578 issued on June 3, 1970 in *Texas Gas Transmission Corp.*,[19a] however, the Commission went beyond the terms of the § 441 election provision and held that a utility like Texas Gas which had elected to switch to normalization with regard to post-1969 expansion property, could also abandon flow through and use liberalized depreciation with normalization as to pre-1970 and post-1969 non-expansion property, in direct violation of the "actual taxes paid" principle of the Natural Gas Act. In arriving at this result, the Commission, citing the House Report, found that the 1969 Tax Act did not affect its authority to reach such a result.[20]

On appeal,[21] the U.S. Court of Appeals for the D.C. Circuit reversed the Commission on the grounds, *inter alia*, that Congress intended in the 1969 Tax Act that the right of election should be limited to post-1969 expansion property

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[19]Though the calculation of the tax expense is the same under straight line as normalization, under the latter method the deferred tax expense is subtracted from rate base. The saving is slight in comparison to that effected by the use of flow through.

[19a]43 FPC 824 (1970).

[20]J.A. 107.

[21]Memphis Light, Gas & Water Div. v. FPC, 462 F.2d 853, *aff'd on rehearing*, 462 F.2d 865 (D.C. Cir. 1972).

only and that the Commission's attempt to go outside the scope of § 441 of the 1969 Tax Act by permitting the switch from flow through to normalization as to *all* property violated (a) the clear intent of Congress to limit the right of election to post-1969 expansion property only[22] and (b) the "actual taxes paid" principle of the Natural Gas Act.[23] The Court arrived at its former conclusion after a thorough and detailed study of the legislative history of the 1969 Tax Act, which revealed that as the tax bill finally emerged from conference, the 180-day election provision was applicable to post-1969 expansion property only and that the provision cited in the House Report and relied upon by the FPC in Opinion No. 578 as authority for allowing a switch to normalization for all property was effectively superseded by the terms of the election provision. In other words, the election provision was inserted to effect a "freeze" of the existing situation by permitting utilities to switch gradually to normalization with regulatory approval as to post-1969 expansion property only; the election provision was not inserted to form the springboard for the wholesale switch to normalization with regulatory approval as to all property.[24] The Court found that such a springboard approach "would be to undo what was most carefully done."[25]

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[22] 462 F.2d at 863.

[23] 462 F.2d at 863-64: "There is nothing in the Tax Reform Act of 1969, then, which modifies the Commission's duty under the Natural Gas Act to require regulated utility companies such as Texas Gas, which had been using liberalized depreciation with flow through with respect to their pre-1970 and post-1969 non-expansion property, to set rates which reflect actual expenditures alone with respect to such property."

[24] It is not disputed that the switch from flow through to normalization for *all* property, if permitted, would result in utilities collecting scores of millions of dollars annually from consumers via increased rates.

[25] 462 F.2d at 870.

ARGUMENT

I

THE COURT BELOW ACCURATELY ANALYZED THE LEGISLATIVE HISTORY OF THE 1969 TAX REFORM ACT AND CORRECTLY CONCLUDED THAT CONGRESS IN SPECIFICALLY LIMITING THE 180-DAY ELECTION PROVISION TO POST-1969 EXPANSION PROPERTY INTENDED TO PRECLUDE REGULATORY AGENCIES FROM AUTHORIZING A SWITCH TO NORMALIZATION AS TO ALL PROPERTY.

The main argument of the Commission (Br. 19-29) and of Texas Gas (Br. 15-36) is that though § 441 of the 1969 Tax Reform Act gave the affected utilities the new right as to post-1969 expansion property to elect within 180 days to switch from flow through to straight line or with the approval of the appropriate regulatory body, to normalization, the 1969 Tax Act did not thereby limit the right of such utilities to seek to switch *at any time* from flow through to normalization as to all property with the consent of the appropriate regulatory body. This tortured construction of the Tax Act produces the absurd result that whereas it is clear that Congress was specifically setting aside post-1969 expansion property for special treatment (i.e. the 180-day election period), under the Commission's and Texas Gas' view the election as to post-1969 expansion property may be used as the springboard to permit the switch from flow through to normalization as to *all* other property *at any time*. The simple answer to this contention is that if Congress had intended this result, it would have so provided rather than isolating one type of property for special treatment. But as the Court below went to such lengths to demonstrate in its treatment of the legislative history of § 441 of the Tax Act, Congress meant what it said when it limited the right of election to post-1969 expansion property only. As the court below so aptly phrased it (462 F.2d at 863),

> What the Commission does by its decision in this set of cases, then, is to produce an effect precisely contrary to that envisioned by Congress in enacting the Tax Reform Act of 1969.

With regard to the futile attempt by the Commission and Texas Gas to find fault with the Court of Appeals' thorough analysis of the Tax Act's legislative history, not only is such attempt analytically deficient[26] but even more importantly, it completely misses the point, which is that if § 441 is not construed as the Court below suggests, then you "produce an effect precisely contrary to that envisioned by Congress in enacting the Tax Reform Act of 1969." *Ibid.* In other words, if Congress had intended to open the door to a wholesale switch by natural gas, electric and other utilities from flow through to normalization as to *all* their property with regulatory approval, it would not have chosen the devious path of permitting a limited election within 180 days as to post-1969 expansion property only; rather it would have adopted the House version of the bill, which would have permitted exactly that result. See chart of legislative history, 462 F.2d at 866. The fact that it made two key changes to the House version, i.e. (1) limited the period for election to 180 days and (2) limited the property subject to election to post-1969 expansion property, demonstrates conclusively that Congress did not intend for regulatory agencies to use the limited election provision as the stepping stone for an across-the-board abandonment of the flow through method. To repeat, had Congress intended this result, it would have so legislated.

Another point glossed over by Petitioners is why, if Congress intended for utilities to have a continuing right to seek to switch from flow through to normalization with regulatory approval as to *all* property, it limited that right in § 441(a) to post-1969 expansion property to be exercised within 180 days.[27] In other words, according to Petitioners, Congress performed an empty act in § 441 by permitting utilities to seek to switch within 180 days to normalization with regulatory approval as to post-1969 expansion property, because they have the same right as to *all* property at *any* time anyhow. The Court

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[26] In our view, the Court's analysis speaks for itself and will not be repeated here.

[27] The FPC does not appear to address this issue at all; Texas Gas' attempt to explain the "overlap" (Br. pp. 23-26) is unpersuasive.

of Appeals correctly determined that Congress was not performing an empty act in its careful wording of the election provision and thus that it could not be used as the springboard for a wholesale switch to normalization as to all property at any time, resulting in multi-million dollar rate increases.

II

THE COURT BELOW PROPERLY RULED THAT THE ATTEMPTED SWITCH TO NORMALIZATION AS TO PRE-1970 AND POST-1969 NON-EXPANSION PROPERTY VIOLATED THE "ACTUAL TAXES PAID" PRINCIPLE OF THE NATURAL GAS ACT WHICH WAS LEFT IN TACT BY THE 1969 TAX ACT.

Though we are confident that the Supreme Court will affirm the Court of Appeals construction of the 1969 Tax Reform Act, it is important to note also that even assuming *arguendo* that Petitioners are correct in their contention that the 1969 Tax Act did not affect the authority of agencies like the FPC to permit normalization as to pre-1970 and post-1969 non-expansion property, the FPC's decision to allow normalization as to that property not specifically covered by the election provision violates the established "rule of Law" under the Natural Gas Act that consumers must reimburse natural gas companies only for their "actual taxes paid",[28] as the Court of Appeals found (462 F.2d at 863-64):

> There is nothing in the Tax Reform Act of 1969, then, which modifies the Commission's duty under the Natural Gas Act to require regulated utility companies such as Texas Gas, which had been using liberalized depreciation with flow through with respect to their pre-1970 and post-1969 non-expansion property, to set rates which reflect actual expenditures alone with respect to such property.

And there can be no dispute that the normalization method (pursuant to which a utility's taxes for ratemaking purposes are computed as though straight line depreciation were being used)

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[28] *E.g., Alabama-Tennessee, supra*, 31 F.P.C. at 211-12.

produces a tax component *above* the actual taxes paid by the affected utility.

The Commission's brief (pp. 3-6, 29-34) attempts to give the impression that the Commission's decision in the landmark *Alabama-Tennessee* case was dictated by circumstances which no longer prevail today and that thus it may be discarded like yesterday's newspaper without so much as a reference to the "actual taxes paid" principle of the Natural Gas Act.[29] However, as the discussion in the statement of the case shows,[30] the Commission in *Alabama-Tennessee* recognized that the "acutal taxes paid" principle of the Natural Gas Act *requires* flow through of the tax benefits accruing from the use of liberalized depreciation, and the only reason that the Commission waited until 1964 to reach that result was that prior to that time it was under the mistaken impression that § 167 of the Internal Revenue Code required normalization (i.e. superseded the "actual taxes paid" principle of the Natural Gas Act).

The Commission's brief (pp. 30-31) cites as the first changed circumstance the present gas supply situation. But the Commission declines to link this up to the key finding in *Alabama-Tennessee* that liberalized depreciation created a permanent tax deferral for a utility with a stable or expanding plant.[31] Not only does the Commission's brief not cite any evidence or finding from the proceeding below that there is a decline in plant investment, but even more telling, the Commission's brief (p. 31) can only conclude weakly (and completely irrelevantly) that "the continued rapid expansion of the natural gas industry can no longer be taken for granted." In brief, the Commission made no findings below (for the good reason that there was no record evidence) that plant additions would not continue to be sufficinet to create a tax saving rather than a tax deferral as the result of the use of liberalized depreciation.

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[29] Texas Gas (Br. pp. 4-5, 62-65) pretends as though the "actual taxes paid" principle does not exist and that the question of what type of depreciation is used is purely a discretionary matter. Texas Gas errs.

[30] Pp. 1-5, *supra*.

[31] 31 F.P.C. at 216.

The second so-called changed circumstance raised in the Commission brief (pp. 31-32) is that since Texas Gas has elected to switch from flow through to normalization as to expansion property for ratemaking purposes, the benefits of liberalized depreciation on such property are no longer available in calculating the company's tax expense on its books of account to offset the effects of declining tax depreciation on the company's books of account arising from the continued use of flow through on existing property. The obvious and fatal flaw in this argument is that Texas Gas did not make its switch re post-1969 expansion property until after it got FPC assurance that it would be allowed to make the switch as to all property.[32] Thus it is sheer makeweight for the Commission to argue that it was in effect forced to allow Texas Gas to use normalization as to all property because Texas Gas had the unexercised right under Order 404 to switch to normalization for post-1969 expansion property. The Commission's abandonment of the established "actual taxes paid" principle by reason of Texas Gas' "proposed election"[33] under the Tax Act is clearly contrary to the letter and spirit of the Natural Gas Act which "was so framed as to afford consumers a complete, permanent, and effective bond of protection from excessive rates and charges."[34]

At most, an equitable argument can be made that since the FPC's Opinion No. 578 allowing the switch to normalization as to pre-1970 and post-1969 non-expansion property is unlawful under the Tax Act and the Natural Gas Act, Texas Gas which relied on Opinion No. 578 should be allowed to revoke its election under the Tax Act as to post-1969 expansion property and continue to flow through as to such property.

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[32] Texas Gas Br. p. 7.

[33] J.A. 108.

[34] Atlantic Refining Co. v. P.S.C. of New York, 360 U.S. 378, 388 (1959).

CONCLUSION

For the foregoing reasons, the opinion of the Court of Appeals reversing Commission Opinions No. 578 and 578-A should be affirmed.

Respectfully submitted,

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